

**BEFORE THE
MASSACHUSETTS DEPARTMENT OF
TELECOMMUNICATIONS AND ENERGY**

**Prepared Direct Testimony of
Stephen H. Bryant**

**for
Bay State Gas Company**

I. INTRODUCTION

1 **Q. Please state your name, affiliation and business address.**

2 A. My name is Stephen H. Bryant. I am Vice President of Regulatory and Government
3 Policy for Bay State Gas Company (“Bay State” or the “Company”). My business
4 address is 300 Friberg Parkway, Westborough, MA 01581.

5 **Q. What are your primary responsibilities for Bay State Gas?**

6 A. I am responsible for overseeing the Company's government policy initiatives, including
7 the Company's interaction with the Massachusetts Department of Telecommunications
8 and Energy (the “Department”).

9 I also coordinate the regulatory and government policy issues of Bay State with Bay
10 State’s parent company, NiSource Inc. (“NiSource”) and with other NiSource local
11 distribution company (“LDC”) affiliates. Together with Bay State, these companies
12 provide natural gas service to more than 3.2 million customers.

1 **Q. Please summarize your professional and educational background.**

2 A. I joined Bay State in January of this year. Prior to joining Bay State, I was Vice
3 President of Marketing Services for Connecticut Natural Gas Corporation from 1997
4 through 2000. My responsibilities included all regulatory matters before the
5 Connecticut Department of Public Utility Control. Prior to joining Connecticut Natural
6 Gas Corporation, I held several positions with Commonwealth Gas Company (now
7 NSTAR Gas), including Vice President of Marketing and Customer Relations.

8 I hold a Bachelor of Arts Degree in Economics from the University of Massachusetts at
9 Boston and a Masters Degree in Business Administration from Boston University.

10 **Q. Have you previously testified before the Department?**

11 A. Yes. I have testified before the Department on a number of issues, including pricing and
12 incentive rate matters. I have also testified before the Connecticut Department of Public
13 Utility Control on issues concerning cost of service and rates, including an incentive rate
14 plan.

15 **Q. What is the purpose of your testimony in this proceeding?**

16 A. Bay State is requesting that the Department approve its proposal to implement a
17 performance-based gas cost recovery incentive mechanism ("GCIM"). The primary
18 purpose of Bay State's proposed GCIM is to achieve a lower overall gas cost for
19 customers than is likely under the Company's existing cost-based gas cost mechanism.

1 The purpose of my testimony is to explain the conditions that led to the development of
2 the proposal, and the benefits that will be achieved over the traditional cost-based
3 regulatory approach. I will review the relevant policy considerations that lead to the
4 conclusion that the GCIM is in the public interest and would lead to lower gas costs for
5 Bay State's customers.

6 In addition, Francisco C. DaFonte, Director of Energy Supply Services for Bay State is
7 sponsoring testimony supporting the structure of the proposed GCIM mechanism. Mr.
8 DaFonte also describes the impact that the mechanism will have on Bay State's gas
9 supply procurement activities, which he directs.

10 **Q. Please summarize your findings.**

11 A. The five principle findings that are supported by my testimony concerning Bay State's
12 GCIM proposal are as follows:

13 **(1) Industry restructuring creates new supply management opportunities**
14 **and risks for LDCs:** A number of important market and regulatory
15 reforms have changed the manner in which LDCs acquire gas supply
16 resources. Today's natural gas markets are much more sophisticated and
17 offer opportunities to tailor purchases to meet unique needs and to manage
18 price risks through financial instruments. The increased complexity that
19 results poses additional financial risks for LDCs who are responsible for
20 providing reliable service at the lowest reasonable cost.

21 **(2) The existing regulatory framework does not encourage Bay State to**
22 **take advantage of available opportunities:** Aspects of the traditional
23 pass-through gas cost mechanisms are a barrier to the use of innovative
24 purchasing strategies. In particular, the risks and rewards of utilizing
25 innovative purchasing strategies and industry-accepted financial tools are

not fairly apportioned. This encourages gas utilities to pursue a more traditional, passive portfolio management approach.

(3) Bay State's proposed GCIM provides appropriate incentives to pursue strategies that are likely to lower gas costs: The creation of an appropriately structured incentive mechanism overcomes the existing regulatory barriers to achieving the lowest-cost gas supply for customers. The proposed GCIM fosters innovative portfolio management with a focused goal of acquiring gas supplies at prices that are below industry-recognized purchasing benchmarks. Further, the mechanism provides for an appropriate sharing of risks and rewards that result from the more aggressive purchasing strategies.

(4) Bay State's merger with NiSource uniquely positions the Company to provide maximum benefits for its customers under the proposed GCIM: The NiSource merger provides Bay State with important experience and scale necessary to maximize the success of the program. Required strict corporate and external controls and oversight are already in place as a result of NiSource's utilization of aggressive portfolio tactics in other jurisdictions. Additionally, NiSource learning regarding strategies that are most effective and that minimize financial risks is directly transferable to Bay State.

(5) Bay State's proposed GCIM is consistent with the Department's incentive regulation and other policy goals: The proposal provides Bay State with greater incentives to lower gas costs and increases the potential rewards for doing so in exchange for assuming a higher degree of cost-recovery risk. Further, the mechanism will introduce regulatory efficiencies by increasing reliance on industry-standard and widely-disseminated purchasing benchmarks to evaluate performance. Lastly, the mechanism does not conflict with the continued promotion of customer choice and competitive alternatives for customers.

Q. How is the remainder of your testimony organized?

A. My testimony is organized into three additional sections following this introduction. Section II provides background on gas industry developments and Bay State initiatives to maximize the resulting opportunities for customers and shareholders. Section III

1 presents an overview of Bay State's GCIM proposal and explains how the mechanism
2 will improve the regulatory framework for evaluating gas supply purchases. Section IV
3 evaluates the proposed mechanism in light of various Department policy goals. Lastly,
4 Section V highlights the benefits of the GCIM proposal and briefly summarizes my
5 conclusions.

***II. NATURAL GAS INDUSTRY DEVELOPMENTS AND ASSOCIATED
DEPARTMENT POLICIES***

6 **Q. Briefly describe changes in natural gas markets that have occurred over the**
7 **last twenty-five years.**

8 A. Natural gas markets continue on a course of broad restructuring that began with the
9 initial deregulation of most wellhead supply prices in 1978 through an act of the United
10 States Congress. Through a series of further physical infrastructure, financial market,
11 regulatory and technological advances, the manner in which gas supplies are traded and
12 delivered to end-use customers has changed entirely. The result is a dynamic and
13 competitive marketplace that is capable of delivering greater value to customers.

14 Twenty-five years ago, pipelines purchased supplies directly in the producing regions
15 under long-term contracts with producers at regulated prices. LDCs, in turn, purchased
16 delivered supplies from pipelines at citygate stations in consuming regions under
17 standard long-term contracts that bundled supplies and deliveries and that were also at

1 Federally-regulated prices. Lastly, consumers purchased supplies bundled with local
2 delivery service from LDCs at state-regulated prices.

3 Today, wholesale natural gas commodity markets are no longer price-regulated and the
4 delivery of supplies to LDC citygate stations is unbundled from supply and storage
5 services. Large volumes of gas are traded at many different pooling points along the
6 interstate pipeline transmission system at transparent prices. LDCs and even many end-
7 users purchase supplies directly from marketing entities under flexible contract terms.
8 Additionally, natural gas contracts are among the most actively traded futures and
9 options in financial markets. Even pipeline capacity and storage is actively traded under
10 more flexible terms in primary and secondary markets.

11 **Q. What are some of the regulatory changes that have affected the development**
12 **of gas markets?**

13 A. The Federal Energy Regulatory Commission (“FERC”) issued a number of important
14 orders that reformed the services offered by interstate pipelines that deliver the bulk of
15 supplies consumed in the U.S. The culmination of FERC’s efforts was Order No. 636,
16 which eliminated pipeline bundled sales, established a secondary capacity market and
17 redesigned pipeline rates. Order No. 636 supported the development of a national
18 marketplace promoting new service options and innovation, and provided participants
19 with the benefits of increased efficiency and competition.

1 More recently, local distribution services have been unbundled to varying degrees in
2 different states. In Massachusetts, for instance, all LDCs offer unbundled tariffs even to
3 residential customers that provide the opportunity to purchase gas commodity service
4 from market participants. Many of the complex details concerning the unbundling of
5 distribution services to retail customers continue to be examined and worked through.

6 **Q. What are the implications of these market and regulatory changes for LDCs?**

7 A. Prior to the changes I have described, LDCs purchased all of their supplies from a
8 limited number of pipelines serving their market area. To a large degree, LDCs relied
9 upon FERC regulatory oversight to ensure that the bundled supplies were reliable and
10 reasonably-priced. Moreover, LDC markets demonstrated reasonable stability from
11 year-to-year minimizing the market risks associated with the long-term contracts
12 required by pipeline providers.

13 Unbundling of pipeline services made available greatly expanded purchasing options to
14 LDCs. The one or two pipeline suppliers serving an LDC have been replaced with
15 numerous options to purchase supply from many suppliers at market centers directly in
16 the producing areas or at a variety of liquid downstream points. The increased trading
17 activity supported the development of financial markets that allow market participants to
18 manage their future price risk through the purchase and sale of futures and options
19 contracts. Finally, electronic trading is emerging as an important means of expanding
20 opportunities for buyers and sellers to conduct business, creating more efficient markets.

1 The advent of new purchasing options and trading channels has greatly increased the
 2 opportunities for LDCs to acquire a portfolio of resources that meets the specific
 3 requirements of their customers. Pricing and other purchasing terms are flexible to meet
 4 the needs of buyers and sellers. Moreover, simple and complex financial transactions
 5 can be utilized in conjunction with physical purchases to achieve desired price hedging.
 6 Lastly, LDCs can mitigate the cost of their pipeline resources through participation in
 7 capacity release and off-system sales markets.

8 The increased financial and physical products and services available to LDCs
 9 significantly increases their responsibility to analyze the costs and benefits of each
 10 purchasing decision in conjunction with an overall portfolio strategy. LDCs have also
 11 assumed the responsibility for ensuring the reliability of supply and other services
 12 required to serve their sales customers, and at the same time, typically serve as supplier-
 13 of-last-resort for competitive retail markets. Additionally, the opening of retail markets
 14 to customer choice has eliminated the stability of an LDC's core market, posing even
 15 greater risks for utilities that must match their resource portfolio to market needs. Mr.
 16 DaFonte will provide additional testimony concerning the increased complexity and risk
 17 that Bay State faces in today's marketplace.

18 **Q. How has Bay State responded to changing industry dynamics?**

19 A. Bay State set out upon a deliberate course of maximizing the benefits that accrue to
 20 customers as a result of opportunities created by the rapidly evolving marketplace. This

1 necessitated that Bay State undertake a series of important initiatives to transform its
2 business. The principal elements of these efforts significantly expanded choice for
3 customers, reorganized the Company along primary customer processes and resulted in
4 the implementation of an incentive rate plan.

5 In conjunction with these efforts, Bay State committed to continuous learning as a
6 critical success factor. It became readily apparent during the implementation of
7 aggressive customer choice and company restructuring efforts that greater scale would
8 significantly enhance Bay State's effectiveness.

9 **Q. Please explain Bay State's efforts to promote customer choice for its**
10 **customers.**

11 A. Similar to many LDCs, Bay State initially offered optional daily-metered firm
12 transportation to large commercial and industrial customers. Bay State subsequently
13 promoted the development of an aggressive non-daily metered residential pilot program
14 in 1996, which was later expanded in 1997. The program terms were developed
15 through a collaborative that received broad participation by local stakeholders as well
16 as national marketers.

17 Bay State was, by all accounts, seeking to bring the benefits of competition to its
18 customers at a more rapid pace than any other LDC in New England. The early pilot
19 program required substantial capital and resource investments in new processes and

1 systems as well as customer communications to ensure its success. Many lessons
2 learned during this early implementation of customer choice for small volume customers
3 guide the Company's continued commitment to deliver the benefits of competition to all
4 customers.

5 **Q. What are the benefits of Bay State's rate plan?**

6 A. The Department initially approved a rate plan for Bay State's base rates in 1997. Bay
7 State Gas Company, D.P.U. 97-97 (1997). The two-year plan was developed
8 together with the Massachusetts Attorney General and the Massachusetts Division of
9 Energy Resources. The plan was subsequently changed by the Department from a rate
10 plan to a price freeze with service quality requirements and extended for five years
11 through 2004 as part of Bay State's merger approval. Bay State-NIPSCo Merger,
12 D.P.U. 98-31 (1998). Bay State's customers have benefited from the initial rate plan
13 through its economic and service quality provisions, which would not have been
14 achieved through a traditional base rate proceeding. Customers continue to benefit
15 from non-traditional rate making under the base rate freeze that replaced the rate plan.
16 Additionally, the service quality provisions under both the rate plan and base rate freeze
17 encouraged positive actions on the part of Bay State to increase customer satisfaction
18 through specific metrics that included penalties for non-performance. The earnings
19 sharing, base rate freeze and service quality provisions provided measurable benefits to

1 customers through incentives that properly align the interests of customers and
2 shareholders.

3 The rate plan also provided the Company with the opportunity to focus important
4 resources on the many efforts that Bay State was pursuing to keep pace with industry
5 changes. In particular, the plan provided funding for the aggressive customer choice
6 initiatives described previously.

7 **Q. What is the significance of Bay State’s merger with NiSource upon these**
8 **efforts?**

9 A. The NiSource merger provides Bay State with many advantages for managing the risks
10 and opportunities created by the ongoing industry changes. In the area of gas supply
11 management, the NiSource merger offers important strategic and practical benefits.
12 Strategically, the combined portfolio presents new opportunities to pursue long and
13 short-term optimization and market development efforts. NiSource also possesses
14 substantial practical experience acquired through the management of its portfolio under
15 price-risk management and GCIM programs adopted by the Indiana Utility Regulatory
16 Commission (“IURC”). This practical experience is transferable to Bay State and will
17 enable Bay State to perform effectively under the GCIM it is proposing to the
18 Department, and includes necessary financial controls and program reporting.

1 **Q. Has the Department taken an active role in promoting customer choice and the**
2 **adoption of incentive regulation?**

3 A. Yes, the Department has devoted considerable time and resources to both of these
4 efforts including the initiation of generic proceedings and the review of company-specific
5 programs for both gas and electric utilities. In promoting customer choice, the
6 Department worked with all interested parties to develop a workable market structure
7 and necessary terms and conditions to enable customers to purchase commodity from
8 competitive suppliers. The Department is also a proponent of incentive ratemaking as it
9 noted in its most recent annual report, where it stated “[a] long-term goal of the Rates
10 Division, as well as the entire Department, is establishing the distribution rates of every
11 gas and electric company using performance-based ratemaking.” Further, the
12 Department most recently indicated in D.T.E. 99-84 that any gas or electric utility filing
13 a base rate proceeding should include a rate plan with a service quality component that
14 is consistent with guidelines issued in that docket.

15 **Q. Please describe your understanding of the Department’s philosophy concerning**
16 **incentive rate mechanisms.**

17 A. The Department provided initial policy guidance concerning incentive ratemaking in a
18 1995 generic order applicable to electric and gas utilities in Docket No. D.P.U. 94-
19 158. In that Order, the Department provided guidance to the utilities and other parties
20 concerning the standard of review that would be applied to incentive ratemaking

1 proposals and also set forth specific criteria that would be the basis for evaluating
2 proposals on a case-by-case basis. The standard of review established by the
3 Department was that any incentive proposal should result in prices that are just and
4 reasonable. The evaluation criteria established by the Department set forth an overall
5 framework for whether it would be appropriate to replace an existing cost-based
6 mechanism with an incentive-based one. The key evaluation criteria are:

- 7 (1) incentive proposals must comply with Department regulations, unless
8 accompanied by a request for a specific waiver. Incentive proposals that
9 comply with statutes and governing precedent are strongly preferred;
- 10 (2) incentive proposals should be designed to serve as a vehicle to a more
11 competitive environment and to improve the provision of monopoly
12 services. Incentive proposals should avoid the cross-subsidization of
13 competitive services by revenues derived from the provision of monopoly
14 services;
- 15 (3) incentive proposals may not result in reductions in safety, service reliability
16 or existing standards of customer service;
- 17 (4) incentive proposals must not focus excessively on cost recovery issues. If a
18 proposal addresses a specific cost recovery issue, its proponent must
19 demonstrate that these costs are exogenous to the company's operations;
- 20 (5) incentive proposals should focus on comprehensive results. In general,
21 broad-based proposals should satisfy this criterion more effectively than
22 narrowly-targeted proposals;
- 23 (6) incentive proposals should be designed to achieve specific measurable
24 results. Proposals should identify, where appropriate, measurable
25 performance indicators and targets that are not unduly subject to
26 miscalculation or manipulation; and
- 27 (7) incentive proposals should be consistent with continued application of
28 FASB requirements and GAAP, and utilities should, if they consider it

1 necessary, discuss the implications of specific proposals with respect to
2 these accounting standards.

3 In addition to the evaluation criteria, the Department also provided guidance with
4 respect to implementation and administration of incentive plans. In particular, the
5 Department stated that incentive proposals should provide a more efficient regulatory
6 approach. The proposals should demonstrate initiative on the part of the utility to
7 manage the program and reduce the Department's burden associated with carrying out
8 its oversight responsibilities. Lastly, the Department stated that incentive proposals
9 should present a timetable for program implementation and specify milestones and a
10 program tracking and evaluation method.

11 Since that time, the Department has addressed a number of specific electric and gas
12 incentive proposals.

13 **Q. Has the Department applied the incentive ratemaking approach to gas cost**
14 **mechanisms?**

15 A. To date, the Department has not adopted an incentive-based approach to utility gas-
16 cost recoveries, nor has such a proposal been made. I strongly believe that the
17 application of the Department's incentive rate policies to gas costs is a logical and
18 appropriate next step that should be explored. This is especially true in view of today's
19 market conditions, discussed previously. The primary objectives of the Department's
20 emphasis on incentive ratemaking for base rates are most certainly applicable to gas

1 costs as well, particularly since gas costs represent a significant portion of a customer's
2 bill. As I will explain later in my testimony, the specific GCIM proposal put forth by Bay
3 State will result in just and reasonable gas prices, and seeks to achieve the other criteria
4 set forth by the Department for consideration of incentive programs.

5 **Q. Are utility commissions in other states exploring alternatives to traditional gas**
6 **cost regulation?**

7 A. Yes. The dramatic price run-up in wholesale gas commodity markets that occurred last
8 year led to a reexamination of gas cost recovery mechanisms and policies in many
9 jurisdictions. Even prior to that time, however, a number of commissions established
10 policies concerning GCIMs or approved utility-specific GCIMs, including California,
11 Illinois, Iowa, Indiana, Kansas, Missouri, Minnesota, New York, Pennsylvania,
12 Tennessee, Washington and Wisconsin.

13 Many of these same states are strong proponents of competitive retail markets as well.
14 The customer choice programs and policies coexist with GCIMs to produce benefits for
15 the broadest group of customers possible. Customers who are not able to receive
16 service from competitive retail marketers due to their own circumstances or a lack of
17 interest among suppliers under market conditions that exist from time-to-time should not
18 be precluded from benefiting from a GCIM. Not only do competitive retail markets
19 and GCIMs coexist in many jurisdictions, Bay State believes that the GCIM will
20 provide an appropriate standard service for customers to evaluate the benefits of

1 competitive offerings. Even states that have pursued the most aggressive model for
2 deregulating supply markets are reevaluating whether customers are benefiting as
3 expected. This further supports Bay State's desire to promote both competitive retail
4 markets and the GCIM as means of providing benefits to its customers. Customers will
5 continue to have the unfettered ability to choose which service best meets their unique
6 needs, which may change as market conditions fluctuate and markets continue to
7 evolve.

8 **Q. Have these other jurisdictions adopted uniform approaches to GCIM?**

9 A. No. However, the various GCIMs reflect a universal principle that an incentive-based
10 approach to regulation results in greater efficiency, reduced oversight burdens, lower
11 costs and provides overall benefits to customers when compared to cost-based
12 regulation.

13 Many elements of the various mechanisms are similar to each other and to that
14 proposed by Bay State. A comparison of GCIMs even within the same jurisdiction
15 would yield material differences also, which are appropriate given the various physical
16 infrastructure and available contractual circumstances of the individual utilities. In
17 particular, the degree of experience with more aggressive gas portfolio tactics and the
18 risk tolerance of each utility and state commission are very different. The development
19 of a one-size-fits-all approach to GCIMs is not appropriate under these conditions.

1 **Q. What relevance should the Department accord the experience of other**
2 **jurisdictions to its review of Bay State’s proposal in this proceeding?**

3 A. The Department should place a primary emphasis on its own regulations and policies,
4 which recognize a preference for incentive ratemaking mechanisms. Additionally, the
5 Department should review Bay State’s proposal on its own merits and in consideration
6 of the benefits that are likely to accrue to Bay State’s customers as a result of its own
7 performance under the plan. Nevertheless, the experience in other states confirms that
8 the application of incentive-based principles to gas costs can yield measurable benefits
9 for customers. Moreover, as demonstrated by the list of states where these
10 mechanisms have been implemented, GCIMs do not conflict with the important policy
11 goals related to promoting retail competition.

III. BAY STATE’S GCIM UNIQUELY CAPTURES OPPORTUNITIES
CREATED BY ONGOING CHANGES IN THE NATURAL GAS INDUSTRY

12 **Q. What is the objective of Bay State’s GCIM proposal?**

13 A. Simply stated, the primary purpose of Bay State’s proposed GCIM is to achieve a
14 lower overall gas cost for customers than is likely under the Company’s existing cost-
15 based gas cost mechanism. In particular, the GCIM will realign the risks and incentives
16 borne by customers and shareholders under existing regulations in a manner that will
17 allow Bay State to more aggressively pursue supply opportunities available in the rapidly
18 changing marketplace. Taking advantage of the increasingly complex offerings in

1 primary, secondary and financial markets is necessary to achieve the lowest cost
2 supplies for customers.

3 **Q. Please describe the essential features of the proposed GCIM.**

4 A. Bay State's proposed GCIM is comprised of two simple elements; a performance
5 benchmark and a sharing mechanism. The performance benchmark establishes the
6 target for measuring Bay State's performance, be it good or bad. To a large degree,
7 the benchmark should be a fair measure of the expected level of gas costs had the
8 GCIM proposal not become effective. Therefore, when performance is measured
9 against the benchmark, the result is an objective assessment of the benefits accrued
10 under the mechanism that result from modifications to Bay State's portfolio management
11 activities.

12 The sharing mechanism specifies how the economic gains and losses that result from the
13 implementation of the incentive approach are apportioned between Bay State's
14 customers and shareholders. The economic gains and losses are calculated by
15 comparing Bay State's actual performance to the benchmark. The structure of the
16 sharing mechanism is important to achieve the intended outcome of implementing the
17 GCIM, i.e., that customers' gas costs are reduced through more aggressive portfolio
18 management. Mr. DaFonte will explain the specific details of Bay State's proposed
19 benchmark and sharing mechanism in his testimony.

1 **Q. How does a GCIM promote lower gas costs compared with traditional**
2 **regulation?**

3 A. As stated previously, today's supply markets offer both opportunities and challenges to
4 Bay State to use industry accepted tools to achieve the lowest cost supply portfolio.
5 Pursuit of this objective requires aggressive and innovative portfolio management with a
6 focused goal of achieving cost-minimization. The GCIM is necessary to foster the
7 desired strategies and performance by Bay State. Specifically, the GCIM would
8 encourage Bay State to utilize appropriate gas supply strategies and financial risk
9 management tools to procure supplies in a manner that balances inherent risks and
10 rewards. Experience indicates that it is necessary to pursue the use of more complex
11 strategies requiring more financial risk in order to realize overall cost reductions,
12 especially, in situations of fluctuating market dynamics. While Bay State's GCIM
13 promotes purchasing strategies that entail a prudent level of financial risk, the proposal
14 does not encourage increased supply-related risks.

15 Bay State's GCIM will also encourage the Company to pursue actions that will
16 moderate price run-ups that can occur in volatile market circumstances. Although the
17 GCIM is not the same as a price stability program, Bay State's proposal promotes the
18 use of available tools to manage volatility. Bay State believes that its proposal
19 appropriately balances the Department's interest in increasing protection as market

1 prices increase without locking customers out of downward price movements that can
2 occur under a gas cost program that focuses on price stability.

3 **Q. Can these same benefits be achieved under the existing gas cost recovery**
4 **framework?**

5 A. Elements of the existing cost-based gas cost mechanism limit the incentives for Bay
6 State to consider all of the options that are available in the marketplace. The dollar-for-
7 dollar pass-through of gas costs is certainly a disincentive for Bay State to assume
8 sufficient risk to secure lower gas costs. Under the traditional gas cost mechanism, the
9 risks and rewards of pursuing non-traditional portfolio strategies are not fairly
10 apportioned. In particular, if Bay State were to pursue a more aggressive portfolio
11 strategy that utilized both physical and financial strategies with the objective of lowering
12 costs, it would increase its level of financial risk without any commensurate increase in
13 opportunity for reward. Bay State would be exposed to greater prudence risks if a
14 particular strategy did not materialize as expected, while customers would reap all of the
15 benefits if expectations were achieved.

16 Naturally, this structure does not promote the type of innovation that Bay State believes
17 will benefit its customers and has been employed to varying degrees by NiSource and
18 other LDCs in other jurisdictions. Instead, the traditional regulatory compact promotes
19 a passive portfolio management approach that is more conservative. While the
20 restructuring of wholesale commodity and transportation markets have directly resulted

1 in important benefits for customers, still greater opportunities will be foregone without a
2 change to the existing gas cost recovery mechanisms.

3 **Q. How will Bay State manage its portfolio differently under the proposed GCIM**
4 **framework than it does today?**

5 A. In general terms, the proposed GCIM will enable Bay State to assume a prudent level
6 of portfolio-cost risk where it is reasonably likely to reduce prices. Additional tactics
7 using non-conventional purchasing strategies and financial instruments will be
8 incorporated into Bay State's overall portfolio management strategies. The specific
9 activities and strategies will depend on market circumstances when the GCIM is
10 effective. Mr. DaFonte provides additional information regarding some of the potential
11 strategies that Bay State might pursue.

12 **Q. What impact does the NiSource merger have upon Bay State's ability to offer**
13 **these benefits to customers?**

14 A. Bay State's merger and participation in the NiSource family of distribution companies
15 provides two benefits that are very important to the anticipated success of the program.
16 The first is experience. Through the institution of a GCIM in 1997 for Bay State's
17 affiliate, NIPSCO, Bay State and its customers will benefit from the real-world
18 experience acquired by NiSource energy supply service personnel. These same
19 personnel will oversee the more aggressive portfolio strategies adopted under Bay
20 State's GCIM providing invaluable benefits that result from years of experience under a

1 similar program. Further, Bay State will directly benefit from the NiSource management
2 controls already in place to support a GCIM in Indiana and other risk management
3 activities. These controls include the establishment of an appropriate corporate risk
4 management policy, a corporate risk management officer, and oversight through a senior
5 executive risk management committee to ensure that only appropriate levels of risk are
6 assumed, and only at times when benefits are likely to result.

7 The second primary benefit is operating scale. With the recent completion of the
8 NiSource – Columbia Gas merger, NiSource’s gas customer base is more than ten
9 times the size of Bay State’s independently. The increased scale provides an important
10 opportunity to manage the financial risks inherent in a more aggressive purchasing
11 strategy across a broader potential earnings base.

12 **Q. Does the GCIM compromise the reliability, flexibility or diversity of Bay**
13 **State’s resource portfolio?**

14 A. No. The GCIM changes the manner in which gas costs are recovered from customers,
15 but does not modify any of the Department’s or the Company’s requirements to
16 maintain a safe and reliable portfolio. Bay State continues to be subject to the
17 Department’s oversight of its resource portfolio.

18 The structure of the proposed GCIM also does not promote exchanging reliability for
19 cost reductions. In particular, the benchmark cost is based on actual volumes

1 purchased and does not provide any incentive to reduce the level of purchases or
2 acquire less reliable capacity. The primary means of ensuring reliability is through the
3 acquisition of adequate capacity, however, capacity costs do not factor into the GCIM,
4 whatsoever. Therefore, it is reasonable to conclude that the GCIM will not degrade the
5 reliability of Bay State's service.

6 **Q. Are you proposing to implement the GCIM on a permanent basis?**

7 A. Bay State is requesting that the Department implement its proposed GCIM for an initial
8 three-year period. This will provide the Company, the Department and all interested
9 stakeholders with sufficient experience to evaluate whether the GCIM should be
10 continued, modified or eliminated. Importantly, this will provide parties with at least two
11 full years of annual storage injection and withdrawal cycles upon which to evaluate the
12 effectiveness of the program before entering a dialog concerning potential changes. This
13 dialog should begin immediately following the second annual storage cycle. It would be
14 more difficult to draw conclusions based on shorter history. Additionally, parties may
15 have some greater clarity concerning the continued development of unbundled retail
16 markets, which may have some bearing upon how to best structure a GCIM applicable
17 to Bay State's remaining sales customers beyond the initial period.

***III. BAY STATE'S GCIM PROVIDES THE DEPARTMENT WITH AN
OPPORTUNITY TO ADVANCE ITS POLICY GOALS***

1 **Q. Would Bay State's GCIM allow the Department to satisfy its statutory**
2 **obligations?**

3 A. Yes. Bay State's proposed GCIM will likely lead to lower overall costs for customers,
4 which is consistent with the Department's mandate in M.G.L. c. 164 to ensure that
5 service is provided to customers at the lowest reasonable cost. Additionally, the
6 Department would retain its regulatory review authority over Bay State's purchasing
7 decisions through its review of semi-annual CGA filings and periodic Integrated
8 Resource Plans.

9 The GCIM would require that Bay State provide additional data at the time it files its
10 CGA to show its performance. These data will facilitate a more streamlined review of
11 the reasonableness of each purchasing decision by comparing each purchasing decision
12 to an independent market index. While the Department will continue to retain its
13 oversight capabilities through the CGA, the mutually agreed upon benchmarks and
14 sharing mechanism associated with Bay State's proposed GCIM will make a *de facto*
15 cost disallowance for any purchase that is outside a predefined band of reasonableness.

16 The Department's review of periodic forecast and supply plans would continue as it
17 does today. These proceedings provide the Department with the opportunity to ensure

1 that Bay State continues to perform its long-term resource planning in a reasonable
2 manner, as well as the opportunity to review individual long-term resource acquisitions.

3 **Q. What are the advantages of applying performance regulation to gas cost**
4 **recoveries at this time?**

5 A. The application of a performance-based approach to gas cost recoveries will offer
6 important advantages to customers under today's market conditions. Under the
7 approach, the Department establishes its objective at the outset, which is to lower gas
8 supply costs for customers without exposing them to unreasonable financial risks. Once
9 the objective is established, Bay State is able to focus its efforts on capturing the
10 maximum value for customers from the opportunities available in wholesale markets.
11 The Company becomes less concerned with the approval of specific strategies and is
12 able to pursue innovation, while at the same time knowing that it will be financially
13 rewarded or penalized depending on how well it performs compared with industry
14 benchmarks. This ensures that Bay State only assumes a level of risk commensurate
15 with the potential upside benefit and its overall risk tolerance.

16 **Q. How will the Department ensure that customers benefit under Bay State's**
17 **GCIM?**

18 A. The premise underlying incentive regulation is that an appropriately designed incentive
19 mechanism will yield better performance and/or lower costs for consumers. The
20 benchmark and sharing mechanisms proposed by Bay State ensure that its incentives

1 are properly aligned with this desired outcome for its customers. The GCIM also
 2 incorporates transparent reporting of Bay State's actual performance enabling the
 3 Department to even more easily review Bay State's supply purchase decisions and
 4 readily identify any areas of concern that should be discussed with the Company or
 5 investigated further. This reporting will facilitate a reconciliation of Bay State's
 6 performance against benchmarks that are widely used in the industry.

7 **Q. Does the proposal incorporate adequate safeguards?**

8 A. Yes. Many of the safeguards are reflected in the ability for Bay State to implement the
 9 necessary management controls and reporting to monitor and proactively manage
 10 greater degrees of financial risk associated with more aggressive portfolio management.
 11 Bay State benefits significantly from its corporate relationship to NiSource, which has
 12 developed strict management oversight mechanisms and daily monitoring activities to
 13 ensure that customers and shareholders are not exposed to unnecessary risks.
 14 Furthermore, the sharing mechanism ensures that Bay State will act in the best interests
 15 of its customers to limit portfolio-cost risks because it will pay a potentially high penalty
 16 for any missteps.

17 Moreover, the design of the proposed GCIM only exposes customers to a limited
 18 degree of price risk. As explained fully by Mr. DaFonte, this price risk only relates to
 19 gas commodity costs and will not exceed four percent of the benchmark cost.

1 Additionally, the mechanism does not alter the existing supply reliability and security of
2 Bay State's portfolio. Thus, a strong safety net exists to protect customers.

3 **Q. Will the approval of a GCIM hinder the development of competitive retail**
4 **markets?**

5 A. The proposed GCIM in no way restricts customers from opting for competitive
6 offerings that may be available in the marketplace. Rather, the GCIM creates the
7 proper platform to appropriately benchmark Bay State's performance, ensuring that
8 customers who are not able to participate, or choose not to participate, in competitive
9 markets receive the lowest-cost service available from Bay State. The GCIM
10 replicates some of the benefits of a competitive market for these customers without
11 actually replacing their competitive service options.

12 **Q. Please describe the consistency of Bay State's GCIM proposal with the**
13 **Department's existing performance-based rate ("PBR") initiatives.**

14 A. Bay State's GCIM is not a PBR. However, the proposed GCIM is consistent with the
15 Department's incentive regulation objectives and is a logical extension of the utilization
16 of those policies to set base rates. The proposal provides Bay State with greater
17 incentives to lower gas costs than exist under the present regulatory framework, and
18 increases the potential rewards for doing so in exchange for assuming a higher degree of
19 cost-recovery risk. Thus, Bay State's proposal is consistent with these core principles
20 enumerated in the Department's incentive ratemaking policy statement.

1 Bay State's proposed GCIM also compares very favorably to the evaluation criteria
2 that the Department reviews in conjunction with an incentive proposal. In particular,
3 Bay State's proposal:

- 4 (1) is consistent with current regulations and statutes;
- 5 (2) enables the continued promotion of competitive markets;
- 6 (3) does not jeopardize safety or reliability;
- 7 (4) focuses on cost-minimization as opposed to cost recovery;
- 8 (5) is broad based covering the majority of Bay State's gas commodity
9 purchases and costs;
- 10 (6) utilizes industry-standard and independently-compiled indices as the
11 performance benchmark; and
- 12 (7) is consistent with existing FASB and GAAP accounting requirements and
13 standards.

14 **Q. Do you believe that Bay State's proposal satisfies the Department's standard**
15 **of review that would be applicable to a GCIM?**

16 A. Yes. The proposed GCIM will result in just and reasonable prices, which is the
17 standard applicable for an incentive mechanism. The mechanism is likely to result in
18 lower overall costs for customers. Additionally, the GCIM represents a reasonable and
19 fair sharing of the economic benefits and risks associated with the portfolio management
20 practices that the mechanism is designed to promote. Lastly, the proposal satisfies the
21 specific criteria that the Department has adopted for evaluating incentive proposals.

1 **Q. How does Bay State’s GCIM proposal compare with its previous proposal to**
2 **utilize price-risk management tools?**

3 A. Bay State’s earlier proposal to utilize price-risk management tools was an initial step
4 toward the ultimate development of a GCIM. The proposal was intended to capture
5 the benefit of NiSource’s experience using these tools for the benefit of Bay State’s
6 customers, and later to incorporate these tools in an incentive mechanism. Bay State’s
7 proposal in this proceeding provides important advantages compared with its previous
8 proposal, in that it provides the Department with an important measurement tool in the
9 form of the benchmark. Additionally, the GCIM also shifts considerable financial risk to
10 Bay State providing the Department with a greater degree of comfort that customers
11 will not be harmed under the proposal.

12 **Q. Since the GCIM offers advantages for customers compared with current CGA**
13 **mechanisms, do you recommend that the Department institute GCIMs for all**
14 **gas utilities in the Commonwealth?**

15 A. The Department is in the best position to assess the capability of a utility to operate
16 under a GCIM, and the likelihood that the LDC’s customers will receive benefits. Bay
17 State believes that it is uniquely positioned to offer the GCIM that it is proposing due to
18 the experience gained by NiSource through the implementation and operation of a
19 GCIM approved by the IURC. NiSource has devoted considerable resources to the
20 creation of appropriate management controls necessary to support the program and to

1 understanding how to best maximize value for customers through innovative gas
2 purchasing strategies.

3 The Department should consider approval of Bay State's GCIM as an opportunity to
4 create a learning laboratory for all interested parties, including other gas utilities. The
5 Department will have the opportunity to adjust Bay State's mechanism after the initial
6 implementation period and will not be precluded from adopting different mechanisms for
7 other utilities in the future. Attempting to evaluate the applicability of a GCIM to all
8 Massachusetts gas utilities is not likely to be the most productive means of moving
9 forward, and may ultimately delay the experience gained from implementation of a
10 mechanism that will benefit Bay State's customers.

1 **Q. Will acceptance by the Commission of the Company's GCIM require any tariff**
2 **changes?**

3 **A.** Yes. Certain changes to the Company's Cost of Gas Adjustment Clause ("CGAC")
4 will be required to reflect the impact of GCIM activities in the cost of gas calculation.
5 Attached to my testimony as Exhibit SHB-1 is a redline version of the Company's
6 currently-effective CGAC with recommended changes to reflect the impact of the
7 GCIM in the cost of gas adjustment calculation. The proposed tariff reflects the
8 detailed structure of the GCIM as explained in Mr. DaFonte's testimony. Mr. DaFonte
9 also provides example calculations demonstrating the simplicity of calculating this new
10 component of Bay State's CGAC.

***IV. BAY STATE'S GCIM EXPANDS THE BENEFITS OF RESTRUCTURING
 FOR ITS CUSTOMERS***

11 **Q. Please summarize the principal benefits that would accrue under Bay State's**
12 **proposal.**

13 **A.** The primary benefit that will accrue to customers through the replacement of the existing
14 cost-based gas cost mechanism with the proposed GCIM is lower costs. This is
15 accomplished by aligning the benefits for Bay State with the desired outcome for
16 customers and restructuring the risk exposure between customers and Bay State so that
17 it will pursue market opportunities aggressively. The GCIM also streamlines the

1 regulatory process by measuring Bay State's performance against benchmarks that are
2 applicable to the industry as a whole.

3 **Q. Why is this an appropriate point in time for the Department to approve Bay**
4 **State's proposal?**

5 A. Although the groundwork for the development of retail competition in Massachusetts
6 has been laid, competitive activity across the entire U.S. has diminished. Therefore, it is
7 expected that Bay State will continue to serve an important role in supplying customers
8 for the next few years. This is especially true for residential and small commercial
9 customers. Bay State's proposed GCIM will enable it to increase the benefits of their
10 service through appropriate supply procurement activities. Bay State's proposed
11 GCIM is particularly suited to present market conditions, which are characterized by a
12 broader selection of available purchasing options and strategies to capture value for
13 customers.

14 **Q. Please summarize your recommendations.**

15 A. As a result of ongoing industry restructuring, Bay State faces new and ever-increasing
16 supply management opportunities and risks that results from the introduction of
17 competitive forces. The existing gas cost recovery mechanism does not encourage Bay
18 State to take advantage of available opportunities, presenting a regulatory barrier to the
19 use of innovative purchasing strategies. The implementation of an appropriately
20 structured incentive mechanism overcomes these barriers to achieving the lowest-cost

1 gas supply for customers. The proposed GCIM fosters innovative portfolio
2 management with a focused goal of achieving cost-minimization and fairly apportions
3 risks and rewards between customers and shareholders. Bay State's merger with
4 NiSource uniquely positions the Company to provide maximum benefits for its
5 customers under the proposed GCIM. Lastly, the proposed GCIM satisfies the
6 Department's standard of review and is consistent with its incentive regulation policy
7 objectives.

8 **Q. Does this conclude your testimony?**

9 A. Yes, it does.